Studies in
Rural Finance

Economics and Sociology
Occasional Paper No. 1473

CENTRAL AMERICAN FINANCIAL DEVELOPMENT

by

Claudio Gonzalez-Vega

and

Jeffrey Poyo

Revised Version
May, 1988

Agricultural Finance Program
Department of Agricultural Economics
and Rural Sociology
The Ohio State University
2120 Fyffe Road
Columbus, Ohio 43210

CENTRAL AMERICAN FINANCIAL DEVELOPMENT

Table of Contents

List of Tables

CENTRAL AMERICAN FINANCIAL DEVELOPMENT

SUMMARY

Claudio Gonzalez-Vega and Jeffrey Poyo

The efficient operation of Central America's financial systems can play a key role in renewed growth and structural transformation in the region. Through monetization, intermediation, and reserve-management services the financial system contributes to market integration, the savings-investment process, and economic development. These contributions of finance depend on the size of the financial sector, in real terms, and on the transactions costs imposed on market participants. With the recent crisis, financial flows declined and transactions costs increased. These results reflected a conflict between these functions of finance and its role as a fiscal instrument.

During the 1960s and 1970s, Central America experienced a significant process of financial deepening. This progress was a consequence of rapid output growth and price and exchange-rate stability, which in turn reflected cautious fiscal and monetary policies. Numerous institutions were created, the network of branches was expanded, and financial magnitudes increased, in real terms and as a proportion of the GDP. Markets remained fragmented, however, and the Central American economies continued to rely heavily on foreign savings. The urban bias of financial development and high transactions costs excluded large segments of the population from access to deposit and loan services.

The Central American financial systems suffered a major blow with the crisis. The financing of fiscal deficits with domestic credit led to inflation, devaluation, the contraction of the real size of the financial system, and the crowding out of the private sector in domestic credit portfolios. This contraction was not uniform; it was at the expense of the private sector, of the mobilization of deposits in domestic currency, of the regulated segment of the market, of the share of productive sectors in loan portfolios, and of the access of the smaller, poorer, riskier producers to financial services.

The financial systems of Central America are dominated by the banking sector, which plays a key role in the savings-investment process. Reluctance to let the market allocate resources has led to the nationalization of the banking system in three countries, to the creation of public development banks and investment corporations, to selective credit controls, to confiscatory reserve requirements, to restrictions to entry into financial markets and to market segmentation, as well as to

interest-rate ceilings and preferential rediscounting programs. Most of these interventions have been unsuccessful and have further increased transactions costs.

The most important challenge for the Central American financial systems will be to provide access to financial services to large segments of the population. This will require policy and procedure reforms, in order to create a hospitable regulatory environment. It will also require cost-reducing financial innovations, in order to reduce the costs faced by depositors, borrowers and intermediaries. High transactions costs reduce the net returns on deposits to savers, increase the total costs of the funds for investor-borrowers, and jeopardize the financial viability of regulated intermediaries. Efficient institutions have to be designed, their staff and management need to be trained, and appropriate incentives have to be created. Technologies, institution building, and policy reforms will then reinforce each other. This is a difficult and expensive task, which requires external assistance for research, experimentation, training, and financing set up costs. Excessive inflows of foreign financial assistance, however, may take away the incentives to mobilize domestic resources and may transform existing financial institutions into mere conduits for donor targeted, concessionary funds. This would further increase financial repression and postpone financial market development.

CENTRAL AMERICAN FINANCIAL DEVELOPMENT

This is a critical period for Central America. Recent geopolitical, social, and economic problems far surpass the difficulties experienced in the 1930s, during the Great Depression, when the region's export earnings sharply declined. High social costs have resulted from the present crisis in view of its depth, its duration, and its impact on each country's institutional framework and political and social fabric. Multiple, accelerating, and dramatic changes have been transforming the political and economic structures of the five countries. As a result, the destiny of the region will be molded during the next few years. The ways in which present economic and political problems will be solved will determine the type of society and the level of welfare to be enjoyed by the Central Americans during the rest of the century.

Political turmoil, insurrection, and the prospects for peace have attracted most of the substantially increased international attention that has recently focused on Central America. Although less emphasized, economic stagnation and instability have also been a major component of the recent history of the region. In the 1980s all five countries have experienced stagnant or contracting output; an even more rapid decline of their international trade, including intraregional trade; growing unemployment and underemployment; huge public-sector deficits and the corresponding public external debt; increasing open or repressed inflationary pressures; and the implicit or explicit devaluation of their currencies. These difficulties have been in sharp contrast with a record of rapid economic growth and sustained price and foreign-exchange stability during the previous two decades.

Numerous plans and programs have been proposed to deal with these problems. A common set of responses has been to request, on the one hand, and to offer, on the other, substantially increased amounts of foreign financial assistance. Large inflows of foreign aid, however, may represent a far more complex and difficult exercise than is usually assumed, while the increased availability of external funds may undermine the will to undertake some of the policy reforms that are essential for renewed economic growth. This is not the place, however, to resolve the issues about the role and dangers of large inflows of foreign aid. Rather, the purpose of this analysis is to examine the role of the domestic financial system in mobilizing and in more efficiently allocating local resources, in order to facilitate stabilization, structural adjustment, and the resupmtion of rapid output growth.

This chapter discusses the importance of the financial sector for economic development, the process of financial deepening that preceeded the crisis in Central America, and the impact of the recent financial repression on the size and performance of the banking sector. Financial deepening is a process of accumulation of financial assets at a rate faster than the accumulation of non-financial wealth. When financial deepening takes place, the real value of key financial magnitudes grows, while the rates of return of financial assets are high. A process of financial deepening reflects the efficiency with which the services of the financial sector are being provided. The opposite is financial repression, characterized by the slow or even negative growth of the real value of financial magnitudes. Financial repression usually reflects incorrect policy interventions. This chapter also examines the nature of the Central American financial systems and of the policies that influence their performance and it explores opportunities for their improvement.

1. The Importance of Financial Deepening

The role of the financial system and the nature of its contributions to economic growth have received increasing attention. These contributions are associated with the provision of at least four types of service. The most basic is the monetization of the economy, that is, the provision of a medium of exchange. This service reduces the costs of conducting transactions in the markets for commodities and for factors of production, it increases the flow of trade, and it enlarges market size. These effects, in turn, improve the productivity of resources, through specialization and the division of labor, greater competition, the use of modern technologies, and the exploitation of economies of scope and economies scale.

The efficiency of the monetization effort is reduced by inflation and currency substitution (dollarization). In order to avoid the negative impact of inflation, economic agents substitute tangible assets (real estate, inventories, jewelry) and foreing currencies for the domestic money. The domestic currency is no longer considered an efficient medium of exchange and store of value. The funds shifted into inflation hedges, however, provide little social returns. Correct macroeconomic management, which avoids inflation, is thus crucial for adequate monetization.

The financial system also provides services of intermediation between savers and investors, thus enhancing the accumulation of capital and improving its allocation. In the absence of financial markets, many producers are condemned to take advantage of their opportunities only to the extent allowed by their own resources. In other cases, when their resources are abundant compared to their productive options, savers are forced to invest those resources at low marginal rates of return. There is no reason to expect that those with the capacity to save, at a given moment, are necessarily those with the best investment opportunities. By making the division of labor between savers and investors possible, financial intermediaries channel resources from producers and regions with a limited growth potential and poor productive opportunities to those where a more rapid expansion of output is possible.

Through the provision of intermediation services, therefore, the financial system contributes to the elimination of inferior uses of resources and, at the same time, it facilitates better alternative uses of these resources. This is accomplished when the financial system offers wealthholders new assets (for example, bank deposits) that are more attractive forms of holding wealth than the unprofitable uses of resources thus eliminated. The intermediary, in turn, transfers these claims on resources to others, who possess better investment opportunities. From this perspective, the financial system offers valuable services and income-increasing opportunities not only to borrowers, but also to depositors. Financial policies must create a balance, therefore, between the incentives offered to depositors (to attract their savings) and those offered to borrowers (to promote investment). Many credit programs and institutions in Central America, however, have relied heavily upon international donor funds and central bank rediscounting, thus ignoring the provision of deposit services, while financial policies have repressed the rewards offered to depositors.

The financial system also facilitates the reduction of risk and the management of liquidity and reserves. Most economic agents accumulate stores of value for emergencies or to take advantage of future investment opportunities. In the absence of attractive domestic financial assets, they are forced to hold foreign currencies, real estate and other tangible assets (inventories, animals, jewelry) that yield low social returns. The financial system reduces the costs and risks of holding precautionary and speculative reserves when it offers attractive forms of holding wealth. At the same time, it reduces the size of the required reserves, provided it offers open lines of credit when needed, and thus releases resources for immediately productive uses.

Finally, the financial system provides services of fiscal support for the public sector. This is an important contribution, in view of weak tax systems and of the absence of markets for securities. While the first three functions (monetization, intermediation, and reserve management) are complementary, this fiscal function of the financial system may be in conflict with the former three. When abused, this fiscal role may lead to inflation, devaluation, and the crowding out of the private sector from domestic credit portfolios. When this happends, the financial system ceases to be an intermediary between private savers and investors and it becomes a fiscal instrument to tax resources away from depositors, in order to finance the public-sector's current expenditures. Financial policy must strive to strike a balance in the provision of these alternative services.

In summary, economic development both depends upon and contributes to the growth and diversification of the financial system. Financial deepening matters to the extent to which it integrates markets; provides incentives for savings and investment; encourages savers to hold a larger proportion of their wealth in the form of domestic financial assets, rather than in unproductive inflation hedges, foreign assets, and other money substitutes; and channels resources away from low-return towards better alternative uses. The extent to which these services are provided depends on the size of the financial system in real terms; that is, on the purchasing power of domestic financial assets. It also depends on the efficiency of its performance, as measured by the magnitude and dispersion of the transactions costs that are imposed on all market participants, actual and potential.

Market fragmentation, the small size of the transactions, the high costs of information, risk and uncertainty increase the costs of financial transactions in developing countries. As a result, the net returns to depositors are low, the total costs of the funds to borrowers (including their non-interest expenses) are high, the size of financial markets is small, the volume of the funds channelled and the variety of the services provided are limited, and time horizons are short. Financial progress requires a reduction of these risks and transactions costs. This cannot be done by decree, as attempted, for example, by usury laws. Rather, financial progress requires greater competition and market integration, the exploitation of economies of scale and of economies of scope, professional portfolio management and portfolio diversification, the accumulation of information, and the establishment of bank-customer relationships. Financial progress thus requires a hospitable regulatory and macroeconomic policy environment, viable institutions, and innovations in financial technology, in order to reduce risks and transactions costs.

2. Financial Deepening in Central America

During the 1960s and most of the 1970s, the Central American countries experienced a significant process of financial deepening and financial markets served as an important mechanism for economic growth. The evolution of the Central American financial markets compared favorably with financial progress in other developing countries, in terms of the traditional measures of performance, such as the number, diversity, and growth of financial institutions, the ratio of monetary aggregates to national income, and the proportion of national savings captured by the financial system.

During that period, numerous institutions were established and the range of services offered was widened; competition in financial markets increased; the network of bank branches was substantially expanded; the returns to domestic financial assets were positive, in real terms; and financial magnitudes, measured in constant prices, grew rapidly. Sustained economic growth and price and exchange-rate stability produced this progress, even in the absence of explicit concern for financial development.

In effect, up to the mid-1970s, the Central American economies were characterized by remarkable price stability. During 1950-1969, the annual increase of the consumer price index ranged from 0.3 percent for El Salvador, to 3.4 percent for Nicaragua, with rates of inflation in Costa Rica, Guatemala, and Honduras of the order of one to two percent per year. None of these countries experienced double-digit inflation until 1973.

In these very open economies, the domestic price level was essentially determined by stable international prices, given a fixed exchange rate. Exchange-rate stability reflected, in turn, the willingness to adopt the fiscal and credit discipline that is required by a fixed exchange-rate system. The central banks of the region revealed a preference for monetary stability and had the power to maintain it. In effect, during the 1950s and the 1960s, the rate of monetary expansion averaged less than 10 percent per year in each one of these countries, despite the fact that incomes were growing rapidly and that the demand for money was increasing at an even faster pace. Costa Rica, the only Central American country that had to devalue in the 1960s, experienced a slightly higher rate of monetary growth (12 percent per year). Even during the 1970s, the average rate of monetary expansion for Central America was only 14 percent per year. Domestic credit, in turn, grew 11 percent per year in the 1960s and 18 percent annually in the 1970s, when inflationary pressures began to mount. As a consequence of openness and of exchange-rate stability, therefore, inflation was allien to the Central American economies until the mid-1970s.

The resulting significant degree of financial deepening was reflected by the growth of the ratio of the money supply (M2), in the broad sense of currency and demand, savings, and term deposits, to the gross domestic product (GDP). For the region as a whole, this ratio increased from 15 percent in the early 1960s to 30 percent in the late 1970s. Table 1 reports, for the whole of Central America, the ratios of the major monetary and domestic-credit aggregates with respect to the GDP. These figures reflect a sustained process of financial deepening through the 1970s.

Table 2 presents, for each one of the countries, the ratios of the money supply in a broad sense (M2) to the GDP, at the end of selected years. By 1961, this ratio was highest in El Salvador and Costa Rica, intermediate in Guatemala, and lowest in Honduras and Nicaragua. These ratios became comparatively high in the mid-1970s, particularly with respect to other Latin American countries that experienced sustained inflationary pressures and more acute financial repression. Nevertheless, as the process of financial deepening slowed down, this ratio reached a maximum in 1976 in Guatemala (25 percent) and El Salvador (33 percent); in 1978 in Honduras (30 percent); in 1979 in Nicaragua (31 percent); and in 1980 in Costa Rica (35 percent). These figures exclude deposits in foreign currency. The lower ratio in Guatemala possibly reflected the presence of large subsistence sectors, while Honduras was the country that experienced the most rapid improvement since the early 1960s.

Table 1

Central America: Ratios of the Major Monetary and Credit Aggregates to the Gross Domestic Product. 1961-1981.

	1961	1966	1971	1976	1981
Currency	5.9	5.5	5.1	5.8	5.9
Demand Deposits	5.0	5.8	6.4	7.6	6.3
Money (M1)	10.9	11.3	11.5	13.4	12.2
Quasimoney	4.4	7.6	10.9	15.6	16.6
Money Supply (M2)	15.3	18.8	22.4	28.9	27.5
Domestic Credit	19.6	23.9	27.2	32.8	41.3
Private Sector	16.1	19.5	22.4	26.1	25.0
Public Sector	3.5	4.4	4.8	6.6	16.4

Source: Computed from data in the Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano.

Table 2

Central America: Ratios of the Money Supply (M2) to the Gross Domestic Product. 1961-1986.

	1961	1966	1971	1976	1981	1986
Costa Rica	18.0	18.3	27.7	31.9	28.8	44.2
El Salvador	19.7	23.0	24.8	32.9	33.7	35.0
Guatemala	13.9	17.7	19.8	25.2	23.1	24.9
Honduras	12.9	16.7	24.7	30.9	28.0	30.6
Nicaragua	11.7	18.0	17.3	28.1	32.2	50.8 a/

a/ This figure reflects problems of measurement for Nicaragua, since there is abundant evidence about disintermediation in real terms in this country.

Source: Computed from data in the Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano.

Most of this impressive process of financial deepening resulted from the growth of quasimoney (that is, savings and term deposits, rather than currency and demand deposits). For Central America, the ratio of quasimoney to the GDP increased from 4 percent in 1961 to 16 percent by 1978. This growth reflected the diversification of financial portfolios, in order to satisfy diverse tastes for returns, risk, and liquidity. Also, as inflationary pressures increased, transaction balances were kept in new forms, different from checking accounts. Deposits denominated in US dollars also augmented in relative importance, particularly in recent times. This reflected the process of currency substitution associated with the crisis. Deposits in dollars accounted for 11 percent of the Costa Rican GDP in 1983, the country where dollarization was more substantial.

Table 3

Central America: Ratios of Domestic Credit to the Gross Domestic Product. 1961-1985.

	1961	1966	1971	1976	1981	1985
Costa Rica	31.9	33.8	36.6	39.1	25.0	40.7
El Salvador	26.6	26.9	30.7	34.8	57.7	54.2
Guatemala	14.5	18.1	17.5	19.7	28.2	38.6
Honduras	11.8	16.2	31.1	43.5	44.7	56.9
Nicaragua	16.8	27.2	30.4	46.3	78.4	99.6 a/

a/ The figures for Nicaragua reflect important measurement errors.

Source: Computed from data in the Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano.

This increasing mobilization of financial resources through the banking system made possible the rapid expansion of credit. For the region as a whole, the ratio of domestic credit to the GDP grew from 20 percent in the early 1960s to 35 percent in the late 1970s (See Table 1). As shown in Table 3, already by 1961 there were important differences among the Central American countries in this respect. At that time, these ratios ranged between 12 percent for Honduras and 32 percent for Costa Rica. The sustained differences observed for the whole period resulted from different degrees of use of central bank credit (inflation tax) and of foreign savings, to complement domestic resource mobilization, particularly during the more recent years.

Despite financial deepening, the Central American economies continued to rely heavily on foreign savings for the financing of their domestic investment. Moreover, domestic financial markets remained highly fragmented, in part as a reflection of underdevelopment, and partly as a consequence of financial policies. A significant degree of urban bias has also characterized the expansion of the banking system. The network of bank branches and the flow of deposits and of loans have been concentrated in the few major cities.

Only a small proportion of the total population has had access to the financial services offered. Lack of access has been acute in the rural areas. The proportion of farmers with access to institutional loans has been less than 15 percent for the region as a whole and has ranged from less than five percent in

Guatemala to over 30 percent in Costa Rica. The loan portfolios of the financial institutions have also shown much concentration. Among those priviledged enough to have access to the loans, a few have captured the largest proportion of the funds loaned. For example, in the case of agricultural loan portfolios, about 10 percent of the number of borrowers have received about 85 percent of the amounts disbursed. This has happened even in Costa Rica, despite the nationalization of the banking system in 1948. Loan delinquency and default have also been increasing. The unpaid loans have thus represented additional transfers of resources to relatively wealthy borrowers.

High transactions costs have been incurred by all financial market participants. In many cases these costs have been so high, that they have excluded large segments of the Central American population from participation in formal credit markets. Government intervention has accentuated market fragmentation and has further increased transaction costs. This intervention has taken the form of interest-rate restrictions, selective credit allocations, high and differentiated reserve requirements, preferential rediscounting schemes, and restrictions to entry into financial actitivities. The increased financial repression that has resulted from the recent economic and financial crisis has accentuated all of these shortcomings of the Central American financial systems. The number of bank clients has declined, the concentration of credit portfolios has increased, and transactions costs have augmented.

Table 4

Central America: Proportion of Domestic Credit Outstanding Captured by the Public Sector. 1961-1985.

	1961	1966	1971	1976	1981	1985
Costa Rica	12.9	17.1	16.7	23.0	46.7	52.4
El Salvador	14.9	15.9	17.3	16.7	51.0	44.8
Guatemala	25.2	27.3	27.4	36.9	40.4	49.4
Honduras	23.4	17.5	20.3	19.7	31.9	36.5
Nicaragua	14.3	9.9	4.6	3.8	29.6	50.7

Source: Computed from data in the Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano. Several years.

3. Financial Represion: The Impact of the Crisis

The Central American countries have been in the midst of an acute economic crisis. The difficulties have resulted from a combination of long-term trends and unfavorable short-term circumstances, both foreign and domestic. The long-term, structural determinants of the crisis have reflected a contradiction between the region's basic characteristics (small, open economies, abundant in labor and with very specialized natural resources) and the features of the protectionist strategy of development adopted in the late 1950s. The penalization of agriculture and the bias against exports have produced high costs and distortions. The short-term determinants of the crisis, on the other hand, have reflected major external shocks, political turmoil, and the unfortunate domestic policies adopted in response to the shocks. The external influences have included sharp swings in the region's international terms of trade and drastic changes in the conditions of its access to international financial markets.

The Central American financial systems have suffered significantly with the crisis, probably more than any other sector in the economy. There has been essentially a fiscal reason for this. When the stagnation and contraction of real incomes in the early 1980s reduced the rate of growth of government revenues (which in some cases became negative even in nominal terms), the Central American governments faced severe political and administrative constraints for an additional mobilization of domestic resources with the use of the conventional tools of taxation. It became difficult to increase taxes in the middle of an economic recession, given pessimistic expectations and intense capital flight. Several attempts at tax reform did not bear the desired revenues. At the same time, public-sector expenditures and implicit, non-recorded subsidies and entitlements kept growing, at rates increasingly faster than those associated with revenues. Moreover, the absence of a significant securities market precluded any substantial placement of government debt with the private sector.

Given the increasing discrepancy between public-sector revenues and expenditures, for a while the authorities financed budget deficits by placing their debt abroad. This has been particularly substantial in Costa Rica and in Nicaragua and significant in the other countries. When the limit to the stock of public external debt which foreign lenders were willing to accumulate was finally reached and programmed expenditures had not been reduced yet, the Central American governments forced the placement of their debt with the domestic financial system. Table 4 reports how the proportion of domestic credit captured by the public sector increased substantially in the five countries.

Domestic financing of public-sector deficits had two consequences. Too rapid an expansion of domestic credit led to the loss of international monetary reserves, to accelerating inflation, and eventually to devaluation. The rate of domestic credit expansion was no longer compatible with price and exchange-rate stability. On the other hand, the private sector was crowded out of domestic credit portfolios. Thus, growing fiscal deficits were financed with the loss of international monetary reserves, accelerating borrowing abroad and, finally, with the inflation tax and the financial repression of the private sector.

To avoid the inflation tax, the Central Americans revised their wealth portfolios, reduced their holdings of domestic financial assets, and increased their holdings of tangible assets (inflation hedges) and of foreign assets (currency substitution). Controls over interest rates and exchange rates, combined with inflation and devaluation expectations, fueled capital flight. Among the consequences was a contraction of the domestic financial systems, as inflation eroded the real value of credit portfolios and of deposit liabilities and as economic agents moved away from domestic currencies. All previously growing financial magnitudes declined, when measured in real terms and as a proportion of the GDP.

Table 5

Central America: Inflation Rates (Annual Percentage Changes in the Consumer Price Index). 1982-1986.

	1981	1982	1983	1984	1985	1986
Costa Rica	37.0	90.1	32.6	12.0	15.1	11.8
El Salvador	14.8	11.7	13.1	11.7	22.3	31.9
Guatemala	11.5	5.0	6.4	3.6	18.0	37.0
Honduras	9.4	9.0	8.3	4.7	3.4	4.4
Nicaragua	23.9	24.8	31.0	35.4	219.5	681.6

Source: Boletín Estadístico. San José, Costa Rica: Consejo Monetario Centroamericano. 1986.

Table 5 shows how inflation accelerated in Costa Rica in the early 1980s and in all of the other countries, except Honduras, in the mid-1980s. Relative price stability in Honduras has reflected substantial inflows of foreign financial assistance. Fiscal control and foreign assistance allowed Costa Rica to reduce the rate of inflation to more moderate levels in the mid-1980s.

Table 6 shows how financial deepening proceeded at an exceptionally rapid pace during most of the 1970s. This process was reversed, however, in the late 1970s and in the 1980s. The extent and the timing of the disintermediation differed from country to country. Due to the use of uniform dates in Table 6, these differences are not shown in full by this table.

In Guatemala, the real money supply (M2) grew rapidly in the 1970s, reached a maximum in 1978, declined - 5.0 percent in 1979, and continued to grow through 1982. This was mostly due to expanding holdings of quasimoney. Inflation accelerated after 1983, as a consequence of a rapid expansion of domestic credit, particularly for the public sector. In real terms, domestic credit declined during the most recent years. The contraction has been dramatic in El Salvador, where political difficulties have been added to economic problems. The broad money supply (M2) declined

Table 6

Central America: Annual Average Rates of Growth of Monetary and Credit Aggregates, in Real Terms. 1970-1986.

	Guatemala	El Salvador	Honduras	Costa Rica
Money Supply (M1)				
1970-1978	7.0	7.0	9.3	11.3
1978-1982	- 2.4	- 6.2	- 1.4	- 3.7
1982-1986	3.1	- 3.4	1.8	4.7
Money Supply (M2)				
1970-1978	9.0	7.7	9.7	16.7
1978-1982	3.8	- 6.4	- 0.5	- 3.6
1982-1986	0.1	2.4	6.8	4.3
Domestic Credit				
1970-1978	8.2	6.8	10.6	13.4
1978-1982	16.5	4.9	2.2	- 8.3
1982-1986	- 6.1	- 6.6	8.1	10.2
Domestic Credit for the Private Sector				
1970-1978	6.6	6.8	9.8	11.5
1978-1982	7.4	- 7.9	- 1.8	- 15.3
1982-1986	- 3.3	- 2.3	8.2	6.1

Data for Nicaragua are too unreliable, so they are not reported here.
Source: Computed from data in the Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano.

rapidly after 1977 and by 1983 it represented only 72 percent of its 1977 level. Money in a narrow sense (M1) represented 59 percent of its 1977 level. In Honduras, where the contraction has been less acute, the dollarization of deposits has been significant. Low levels of inflation in this country have been due to massive inflows of foreign assistance, which have made it possible to divert inflationary pressures towards imports and to finance them with the loss of reserves. The contraction was dramatic in Costa Rica. The money supply (M2) had grown more rapidly than in the other countries, but it then declined. By 1982, the real money supply was only 74 percent of its 1978 value.

As a result of the contraction of the real size of the financial system, the ratio of M2 to the GDP declined in the four countries (data for Nicaragua are not reliable). In Costa Rica, this ratio dropped from 41 percent in 1980 to 29 percent in 1981. If dollar-denominated deposits are excluded, the reduction was from 35 to 21 percent. In El Salvador, this ratio diminished from 33 percent in 1976 to 29 percent in 1980.

The rapid expansion of domestic resource mobilization that took place during the 1970s made the increase of domestic credit possible. In Costa Rica, real domestic credit increased through 1980, helped by increasing borrowing abroad by the banking system, but it then declined -30.4 percent in 1981 and -22.4 percent in 1982. This last year, its real value was only 54 percent of the 1980 level. That is, the inflationary pressures generated by the rapid expansion of domestic credit (in nominal terms) eventually resulted in a contraction of its real value. In the race between growth of domestic credit in nominal Colones and inflation, the latter was the easy winner. A similar process took place later in Guatemala and in El Salvador.

The proportion of domestic credit allocated to the public sector was fairly constant during the 1960s and early 1970s, when it ranged between 17 and 20 percent of the total. During the second half of the 1970s, however, it increased rapidly. By 1982, it was 44 percent for Central America. That year, the proportion of domestic credit granted to the public sector ranged between 34 percent in Honduras and 51 percent in El Salvador (See Table 4).

Domestic credit for the private sector grew exceptionally fast in Costa Rica in the 1970s, and afterwards it dramatically declined. By 1982, domestic credit for the private sector represented only 49 percent of its 1978 value. That is, the private sector was receiving less than one-half of the purchasing power that it obtained from the banks a few years earlier. Domestic credit for the public sector continued growing after 1978, but eventually it also declined. By 1982, domestic credit for the public sector represented only 58 percent of its 1980 value. The clear lesson is: too rapid an expansion of domestic credit, in nominal terms, resulted in reduced real credit flows, even for the public sector.

While this contraction of the real flows of domestic credit was taking place, the flows of external credit were also being curtailed, and inflation was severely reducing the real value of the working capital of firms. Therefore, the financial crunch was acute from all sources. Moreover, significant portions of the portfolio of the banking system, particularly in the case of the government-owned banks, became overdue. Since defaulted loans have not been written off, the volumes of credit outstanding reported here overestimate the true availability of loanable funds.

The decline of these financial ratios has also reflected, in part, the loss in relative market share of the regulated, institutionalized market, for which the central banks report statistical information. In recent years, there has been almost everywhere a vigorous development of non-regulated financial institutions. Not constrained by central-bank and interest-rate regulations, these intermediaries have been more aggressive than the formal market in the mobilization of domestic resources. In this sense, the reduction in the levels of financial intermediation has been less than reported here.

The contraction of the Central American financial sectors has not been uniform. The private sector has been crowded out from domestic credit portfolios, while the public sector has significantly increased its share. Non-regulated intermediaries have gained the expense of institutional markets, while dollar-denominated deposits have expanded at the expense of deposits in domestic currencies. The share of "productive" sectors in credit portfolios, particularly that of agriculture, has declined, while the share of more "speculative" activities has increased.

With inflation and devaluation, the opportunity cost of holding domestic financial assets has increased. These assets have become poor stores of value and have forced savers to look for alternative ways to hold wealth. As a result, the financial sector has shrunk. This, in turn, has reflected an abuse of the fiscal function of financial markets, which has reduced their ability to promote stability and growth. This is unfortunate, because financial intermediation is critical during periods of structural adjustment and resource reallocation.

4. Financial Market Structure

One of the main features of the financial systems of Central America is the predominance of the banking sector and, within his sector, the dominant role of the commercial banks. As in other developing countries, open markets for common stocks, mortgages, bonds, or even commercial bills are inexistent or insignificant.

This simply reflects the low levels of per capita income and the resulting small scale of individual savings and investment transactions. Information is insufficient to have small farmers or merchants issue their own notes or shares to be publicly traded. As a result, private financial savings are largely held in the form of currency and bank deposits. Within the modern sector of the economy, bank loans represent the most important source of funds for firms, both for working capital and for investment. Thus, banks and similar intermediaries play a key role in the savings-investment process and in the allocation of resources.

The financial systems of the Central American countries include commercial banks, mortgage banks, and development banks, as well as near banks such as savings and loan associations (with the exception of Guatemala) and finance corporations (financieras), capitalization companies, and insurance companies. There is a wide spectrum of non-regulated intermediaries, as well. In Guatemala, bonded warehouses (almacenes de depósito) have become very important as a source of short-term working capital for private firms.

Table 7

Central America: Number of Commercial and Development Banks and Number of Bank Branches, 1986.

	Number of Banks			Number of Branches			Population
	Total	Private	Public	Total	Private	Public	per Office
Costa Rica	17	13	4	248	13	235	9,950
El Salvador	9	1	8	104	4	100	50,272
Guatemala	20	17	3	234	147	84	33,775
Honduras	14	13	1	234	203	31	18,106
Nicaragua	5	0	5	203	0	203	15,064

Source: Guía Bancaria Latinoamericana, 1986. Bogotá, Colombia: Federación Latinoamericana de Bancos.

In addition, in each one of the countries there is a fairly active cooperative movement which also provides financial services, although its relative size within the financial system is still fairly small. Financial institutions other than the commercial and development banks and credit unions are completely concentrated in the large urban centers. In Honduras, for example, 91 percent of the value of all deposits, 93 percent of the volume of loans, and 97 percent of all central-bank rediscounts and foreign-assistance credit flows have been concentrated in Tegucigalpa, San Pedro de Sula, and La Ceiba.

Table 7 presents the number of commercial and development banks and the number of branches in each one of the countries. The financial systems of Guatemala and Honduras have been composed predominantly of private-sector institutions. With the crisis, however, the public development banks have maintained a priviledged access to central-bank rediscounting and to funds from international donors, while the private banks have faced severe constraints on funds mobilization and lending activities. Thus, there have been important changes in market shares.

The Costa Rican banking system was nationalized in 1948 and only the four public commercial banks have been allowed to mobilize demand deposits and savings accounts from the public. Only these banks have enjoyed access to central-bank rediscounting. Recently, however, private banks, which are allowed to offer only long-term certificates of deposit, have gained in market share at the expense of the nationalized banks. This has reflected both the rigidity and obsolescense of the public banks, which had become used to operating without competition, and the aggressive behavior of the private banks, heavily supported by USAID (the U.S. Agency for International Development) with loanable funds in the form of long-term lines of credit and quasi-capital contributions. This support has reflected the shift of USAID programs from the public to the private sector, in an effort to strengthen private enterprise and the market forces. On the other hand, the banking systems of Nicaragua and El Salvador were also recently nationalized, at a time when there has been this increasing privatization trend in Costa Rica. While the recent developments in Costa Rica have been fueled by growing unhappiness with the public banks, those other two countries have placed all of their trust in the ability of the public sector to become an efficient financial intermediary.

Costa Rica possesses not only the lowest ratio of population per bank branch in Central America but, it has also the third lowest ratio in Latin America, after Uruguay and Trinidad-Tobago. In addition, a large portion of this network are rural branches (<u>Juntas Rurales de Crédito Agrícola</u>), created in 1914, which have allowed a greater penetration of the countryside with credit than in the other countries. Access to banking services, on the other hand, has been most restricted in El Salvador and Guatemala.

Attempts to develop a securities market in El Salvador and Nicaragua have failed. Recently much emphasis has been placed on such an objective in Honduras and Guatemala, on the other hand. The creation of a stock market in Honduras, however, is still in the planning stages and a very small stock exchange is functioning in Guatemala. In the case of Costa Rica, the overwhelming proportion of the stock exchange transactions, both in number and in volume, involve public-sector debt instruments. Private-sector participation has steadily grown over the past ten years, particularly as financial repression reduced the relative importance of the banking system, but the trading in shares is still insignificant even in Costa Rica. More than a market for shares, the stock exchange in this country has been a market for obligations.

5. Financial Policies and Regulation

Banks have been frequently criticized for contributing little to economic development. Commercial banks have been seen as too averse to risk and as too slow to supply credit for new, non-traditional, new investment opportunities. The ostensible justification for the nationalization of banking in Central America has been the presumed unwillingness of private banks to channel resources to priority sectors. The pool of financial savings has been perceived as a kind of a "public good," whose optimal use can be achieved only if the state intervenes in the process of financial intermediation. The experience of Costa Rica, where banks have been nationalized for four decades, raises serious doubts about the advantages of nationalization in practice. The government banks have been slow, conservative, and vulnerable to political pressures. With their bureaucratic procedures, they have imposed high transactions costs on their customers. Rigid institutional structures, inadequate incentives, and inconsistent objectives have made them increasingly unable to respond to the dynamic demands of a complex economy in transformation. Nationalized banks in El Salvador and Nicaragua have discovered that a simple change of ownership is not enough to improve performance. Similarly, the region's public development banks have exhibited a sad record of portfolio management and financial viability.

In addition to nationalization, several policies and regulations have been used to redirect funds towards preferred sectors. With the assistance from international donors, several specialized public development banks (particularly agricultural banks) were established throughout the region in the mid-1950s, in order to target loans, at preferential interest rates, to specific sectors. Many of these banks have gone bankrupt several times, but they re-emerge, with a new name and under new management. Frequently, their portfolio includes a substantial proportion of overdue loans, since collection is not a major concern for these institutions. Rather, they are conduits for central bank, government, and donor funds that need to be rapidly disbursed for political or bureaucratic reasons. Since the interest rates that they charge seldom cover their costs and losses from default, these banks must be periodically recapitalized, in order to continue to operate. Similarly, in the mid-1970s several industrial and development investment corporations were created (e.g., CODESA in Costa Rica, CONADI in Honduras) to promote the establishment of new enterprises too big or too risky for the private sector. These agencies failed, too, mostly because they were run with political rather than financial criteria. They are now in a process of dismantling or of privatization, with the assistance from international donors.

Attempts have also been made to redirect the resources mobilized by private commercial banks. These have included confiscatory reserve requirements and selective credit controls. For many years the Central Bank of Costa Rica established topes de cartera, administratively set ceilings and floors on the amount of credit to be granted by sector of economic activity, crop, or other specific criteria. These quantitative restrictions on credit failed because the authorities could not adequately predict demand. Such controls were futile in the first place, given the fungibility of credit. Loans provide the borrower with generalzed purchasing power and the lender cannot control marginal substitutions of these funds for other funds under the borrower's control. Only a complete account of all of the borrowers sources and uses of funds would allow a determination of the actual use of the borrowed funds. The Central Bank of Costa Rica no longer dictates to the nationalized commercial banks the allocation of their portfolio. Rather, it employs reserve requirements and open-market operations for general monetary management.

In most of Central America, high inflation rates combined with interest-rate ceilings resulted in negative interest rates in real terms in the 1980s, as shown in Table 7. These negative rates have jeopardized the ability of the regulated financial institutions to compete with non-regulated intermediaries and to attract deposits from the public. Negative interest rates on loans have generated an excess demand for credit, which has required non-price forms of rationing to clear the market. This rationing has been frequently based on collateral or on buraucratic considerations, rather than on creditworthiness and the selection of the best investment projects. Loan approval criteria have been vulnerable to the influence of strong pressure groups or to the abuse of political power, particularly in the case of the public development banks. Negative interest rates have also discouraged loans that involve more than a minimal risk and administrative costs. These interest rates have not been sufficient to cover the costs and risks associated with the administration of a credit portfolio that includes more than a traditional clientele, unless the institution has been willing to incur in operating losses and to risk getting decapitalized. Thus, to remain financially viable, many intermediaries have restricted their operations to the largest and safest of their clients, while smaller, poorer, or more innovative producers have been denied access to the subsidized loans. These underpriced loans, however, have transfered a substantial income subsidy to a few privileged borrowers. While the majority have been excluded from access to

Table 8

Central America: Representative Real Interest Rates on Loans and Deposits (percentages). 1982-1986.

	1982	1983	1984	1985	1986
Loans:					
Costa Rica	- 32.0	- 5.1	12.4	9.7	10.9
El Salvador	3.4	1.0	2.0	- 5.3	- 10.4
Guatemala	7.0	8.2	- 6.9	- 14.0	- 16.9
Honduras	10.5	7.6	10.7	9.0	10.0
Nicaragua	- 6.5	- 11.4	- 14.9	- 62.3	- 82.7
Deposits					
Costa Rica	- 34.2	- 8.0	9.9	5.0	6.4
El Salvador	- 0.9	- 2.7	- 1.8	- 8.6	- 15.2
Guatemala	4.1	5.3	- 9.4	- 16.4	- 19.1
Honduras	5.3	1.8	5.0	3.8	4.6
Nicaragua	- 11.4	- 15.6	- 16.5	- 62.7	- 82.8

Source: Boletín Estadístico, San José, Costa Rica: Consejo Monetario Centroamericano, 1986.

credit and thus to the transfer, only a few have benefited from the subsidy. At the same time, the institutions created to promote development have been destroyed.

This regressive impact of the subsidy has characterized even the nationalized banking systems. During the 1970s the implicit subsidy was substantial in Costa Rica. The real rate charged on loans during 1974, for example, was a negative -20 percent. Under the conservative assumption that the social opportunity cost of the funds was 10 percent per year in real terms, the implicit rate of subsidy was 30 percent. At that time, agricultural credit represented close to 60 percent of the value of the gross agricultural output and over one-half of the loan portfolio of the nationalized banks. This meant that, in the important case of agriculture, the grant transferred through subsidized credit was equivalent to 20 to 25 percent of the value of the gross agricultural output. On the other hand, only between 30 and 40 percent of the agricultural producers had access to bank credit, while the remaining 60 to 70 percent were excluded from the subsidy.

In addition, there was a high degree of portfolio concentration. In effect, in the case of the Banco Nacional de Costa Rica, which grants over one-half of all agricultural credit in the country, less than two percent of the borrowers (number of loans) received over 60 percent of the amounts loaned for agriculture. About 10 percent of the number of loans corresponded to over 83 percent of the amount of credit granted. This meant that about one percent of the agricultural producers of Costa Rica received over 65 percent of the agricultural credit granted by the banks and over 65 percent of a substantial subsidy. This subsidy was equivalent to almost 25 percent of the value of the agricultural output in 1974.

Due to the decline in inflation rates during the second-half of the 1970s, as well as the increase in nominal rates of interest, the magnitude of the subsidy declined, but it remained important. The subsidy significantly increased again during the early 1980s, while concentration of the loan portfolio became more accentuated. In addition, by the end of the decade it was estimated that about 50 percent of the loan portfolio of the nationalized banks represented defaulted loans. There was a significant transfer on this count, too, to the few priviledged very large borrowers who did not repay their loans.

In addition, the banking regulatory structure has severely restricted competition among different intermediaries, via interest-rate controls, market segmentation, and loan targeting. In view of the recent political and economic instability, moreover, the maturity of both assets and liabilities has been severely shortened. Improvements in banking technology and the promotion of new financial products have lagged behind developments in other countries. In fact, some of the most interesting innovations in the Central American financial markets have ocurred in institutions which were originally established outside, and in some cases remain outside, the regulated banking system. Higher risks and costs are associated, however, with these markets.

In Costa Rica, particularly in recent years, there has been an improvement of the regulatory environment, as the Central Bank has attempted to inject a greater degree of competition and efficiency into the financial market. Interest-rate controls have been significantly loosened and selective credit allocations have virtually disappeared. This has reversed the severe disintermediation trend of the early 1980s. In Honduras, attempts to reduce domestic inflation and to maintain a fixed exchange rate with the use of substantial foreign financial assistance have produced positive real interest rates, too. Nevertheless, it is the increasing claim of the public sector on domestic credit that has been mostly responsible for the comparatively high real rates of interest rates observed in Honduras and Costa Rica. Attempts to artificially reduce these interest rates, however, would only lead to greater disintermediation and to excess credit demands from the private sector, given the prevailing crowding out effect. The artificially lower interest rates will not make available to productive firms the funds that are being captured by the government, while the reduced ability to mobilize deposits will make loanable funds even more scarce. Only fiscal austerity would allow a reduction of the real interest rates in these countries.

In Guatemala, on the other hand, there have been no significant attempts to liberalize financial markets, which continue to operate under a rather repressive regulatory framework. Finally, in both El Salvador and Nicaragua, state intervention in financial markets has been expanded, with the complete elimination of competition for and market allocation of funds, and the transformation of this sector into a public monopoly. Unfortunately, the problems that the nationalization of these banking systems has set out to resolve are more intractable than this simplistic solution assumes, while nationalization itself may create distorted incentives for the operation of these institutions, which may lead to unexpected and unintended results.

6. Financial Market Development

The most important challenge for the Central American financial systems is to provide access to a wide set of financial services for the majority of the population, particularly in the rural areas. The provision of financial services, however, is a difficult and expensive task. Success will depend upon many factors. These include key features of the environment, the degree of organization of society, the impact of non-financial and of financial policies, the design of financial institutions and instruments, and the choice of appropriate technologies to produce financial services.

The features of underdevelopment explain in part the difficulties. Potential depositors and borrowers are very heterogeneous, they are geographically dispersed, their transactions are small, and they face high risks. It is difficult for intermediaries from outside the local communities to acquire and interpret information about their creditworthiness. The result are high transactions costs, which increase the total cost of funds for borrowers, reduce the net returns on deposits for savers, and diminish the profitability of potential intermediaries. Lenders perceive that the costs of managing numerous small savings accounts and of determining the creditworthiness of small, diverse producers are too high, given the scarcity of information, and the nature of the risks involved.

What matters for production and investment decisions is the total cost of borrowed funds. In addition to interest payments, the total cost of borrowing includes explicit and implicit non-interest costs, such as legal, document, and registration fees, commissions, forced purchases of other financial services, taxes, transportation and lodging expenses, the opportunity cost of the time spent in conducting the loans transactions and in preparing investment plans, the costs of entertaining bank officials, and bribes. Compensating balances required from borrowers, delays in the disbursement of funds, and insuficcient financing which results in lower yields also increase borrowing costs.

What matters for savings is the net return to depositors, which are reduced by taxes, penalties for early withdrawal, lodgind and transportation expenses, and the opportunity cost of the time spent in depositing and withdrawing funds. In turn, intermediation margins must cover mobilization and lending costs, to generate a profit for the intermediary. These costs include the administrative expenses associated with deposit accounts, promotion costs, the impact of reserve requirements, loan handling costs (documentation, record-keeping, disbursement), and costs to reduce the risk of default (loan evaluation, monitoring, supervision, and collection), as well as the losses due to lack of prompt payment.

All components of these transactions costs are high in Central America. In the case of the nationalized banking system of Costa Rica, the average non-interest costs of borrowing for agricultural loans were 11.5 percent per year, to be added to average interest payments of 13.6 percent per year. Moreover, while interest rates ranged between 8.0 and 26.5 percent, non-interest borrowing costs ranged between 0.2 and 117.5 percent per year. This enormous dispersion of transactions costs across borrowers reflected a negative correlation with loan and farm size. These costs made financial transactions prohibitive for the smaller, poorer, more remote potential borrowers.

Lending costs have also been high, particularly in the rural areas. In Honduras, in 1982 lending costs averaged 18.8 percent for an agricultural development bank and 8.4 percent for the agricultural loans of a major private commercial bank. A substantial portion of these lending and borrowing costs has been associated with the rationing mechanisms which are necessary in the presence of excess demands for credit, given under-equilibrium interest rates. These transactions costs have also been related to the loan targeting usually required by international donors and to the screening, documentation, supervision, and extensive reporting requirements that are inevitably associated with a multitude of separate special lines of credit and with selective credit controls.

Insufficient organization also increases the costs and risks of financial transactions. If property rights are not adequately defined and if contracts cannot be simply specified and successfully enforced, only the least risky financial transactions take place. In the absence of proper land titles, the offer of adequate collateral is not be possible. This institutional deficiency slows down the penetration of the banks in the countryside. When there are no efficient, impartial courts, loan contracts have no meaning and banking is shallow. When information is expensive, unreliable, and not accessible, the most important input in the financial production function is missing. Where there are no roads, people cannot visit bank branches. Where potential customers cannot read or write, they cannot fill a loan application and communications are more costly. Where there is no adequate supervision of the financial system, depositors will not be protected.

Economic policies that repress growth and incomes in specific sectors of the economy (for example, policies that repress rural incomes) constrain deposit and loan demand and reduce creditworthiness. The strength of financial institutions depends on the solvency and dynamism of their clientele. Producers who receive low prices for their output, pay high prices for their inputs, obtain poor yields, and do not have access to markets and to public services are not good bank clients. For these reasons, the crisis not only shrank the size of financial markets, but it also reduced the quality of loan portfolios, given the deterioration of the economic situation of the banks' clientele.

As pointed out, rigid financial policies also contrain the growth of financial markets. Inflation and devaluation expectations, combined with interest-rate ceilings, reduce the net returns to be earned on domestic financial assets and lead to currency substitution, the accumulation of financial hedges, and the contraction of the financial system. The financing of fiscal deficits with bank credit leads to the crowding out of the private sector in credit portfolios.

In a highly restrictive regulatory environment, with binding interest-rate ceilings and a significant excess demand for credit, where bankers are protected from competition by barriers to entry and to exit and by market segmentation, it is not surprising that banks do not go out of their way to venture into risky territory; they simply ration credit to the least risky and costly clientele. The ability to evaluate and take risks, which is the banks' most important function, is never tested or exercised. The internal rate of return or cash flow of a particular project becomes of secondary importance, while the supply of collateral takes the place of project and creditworthiness evaluation. In this environment, financial market regulation provides incentives and government sanction for the oligopolistic behavior of banks. Reforms of the regulatory framework should attempt to reduce the degree of specialization in financial markets, as experienced has shown even in the much larger financial markets of the United States, and they should promote the ability to diversify, geographically, and in terms of maturities and loan uses.

Financial liberalization is not easy, however. Although increased competition will provide incentives for innovation in financial products and technology, it may at the same time increase fragility. There are difficulties in the transition, when the detailed rules under which the banks have become used to operate are modified and these institutions are given greater degress of freedom and are forced to formulate strategies and accept responsibility for their decisions. To head off potential negative effects of the reforms, significant improvements must be made in the banking supervision functions of the monetary authorities (superintendency of banks). In addition, training programs would be an important instrument with which to improve the managerial abilities of bank executives and to increase their capacity to flexibly respond to a more competitive environment.

Design contributes to the success or failure of financial institutions. Multiple and inconsistent objectives, frequently found in public development banks, reduce institutional viability. Undue specialization increases risks and the potential for moral hazard. In particular, the absence of deposit mobilization activities seriously weakens financial institutions. Specialized retailers of central bank or donor funds have been particularly unsuccessful. Unless authority for the evaluation of creditworthiness and for the collection of loans is granted and accountability is specified, the intermediary will be crippled. Political intrusion must also be avoided.

The evaluation of risk requires information. Mutual organizations and other base-level institutions, such as credit unions, have a comparative advantage in servicing low-income groups, in view of their access to the relevant information and a favorable cost structure. Their financial strength derives from the mobilization of local deposits. Policies directed to linking these intermediaries to the regulated, institutionalized financial markets, by improving their access to funds and providing technical assistance, may significantly improve access to financial services by the marginal populations.

The development of securities markets may help to redistribute risks more efficiently. The ability to attract investors directly, through the sale of shares, would improve access to financial markets on the part of entrepreneurs with relatively risky projects, who at present cannot obtain the necessary resources. Development of the securities market would also reduce the very high levels of credit leverage which characterize Central American firms. An excessive reliance on debt, rather than equity, has been one of the weaknesses of the Central American private sector. Again, a concerted effort to produce the required information is indispensable if such a market is to be developed. Given the small size of the market, uncertainties about the future, and the high costs of information, nevertheless, it will take a long time for a securities market to significantly contribute to economic development. Efforts towards improvement of the financial systems of Central America, therefore, should not focus entirely, not even as a priority, on the development of stock exchanges. Financial market development in the region will continue to rest largely upon progress of the banking industry.

For all of these purposes, cost-reducing innovations will be needed, in order to increase access to financial services and to improve their quality. Incorrect incentives have stunted financial innovation in the past in Central America. Once the regulatory framework becomes more hospitable and financial prices are allowed to reflect true scarcities, however, institutional experimentation and product development will be needed.

7. Conclusions

Renewed economic growth and structural transformation in Central America will require a substantial reallocation of resources, innovation, the ability to identify and take advantage of new and different productive opportunities, and the capacity to evaluate and take reasonable risks. The efficient performance of the financial system, particularly in its intermediation function, will be a key determinant of the success of these efforts. The contributions of the financial system will depend on the volume of resources mobilized, on the ability of the market participants to identify the investment projects with the highest social marginal rates of return, and on the efficiency of the financial transactions. Such efficienty will be mostly reflected by the magnitude and the dispersion of the transactions costs imposed on all market participants, both actual and potential, and by the divergence of marginal rates of return in the economy.

A sharp reduction in the real value of financial flows has accompanied the recent economic and political crisis in Central America. This reduction has severely constrained the availability of loanable funds for investment and for working capital. The contraction has had a fiscal root. Inflation, devaluation, and the crowding out of the private sector in domestic credit portfolios have been the result of large fiscal deficits financed with bank credit. A reduction of this financial repression will require the restablishment of fiscal and monetary discipline. Successful macroeconomic management, therefore, is a major precondition for the efficient performance of the Central American financial sector.

High transactions costs, which already reflected the consequences of underdevelopment, have been augmented by unnecessarily detailed regulations and restrictions on the operations of financial intermediaries. Transactions costs have also been increased by the targeting of loans through a multitude of concessionary credit lines (for specific crops, inputs, or investments), each one with its own eligibility conditions, lending terms, and reporting requirements. Because of the fungibility of money, however, targeting does not guarantee additionality. In most cases, there is little correlation between the proposed use of the funds and the marginal activity actually promoted by the loan. Targeting, on the other hand, increases transactions costs and makes apparently "cheap" credit expensive. These transactions costs have reduced the net returns to saver-depositors, have increased the total effective costs of the funds for investor-borrowers, have endangered the financial viability of banks and of other financial institutions and, in particular, have excluded important segments of the population from access to financial services, specially in the rural areas.

The most important challenge for the Central American financial systems, therefore, is to provide increasing access to financial services for the majority of the population, in ways which contribute to growth and structural transformation. For this, an appropriate policy and regulatory environment has to be established, new cost-reducing financial innovations have to be designed, tested, and adapted to the local circumstances, and viable institutions have to be promoted. This is a difficult and expensive undertaking.

If the policy environment is not hospitable, financial intermediaries will not survive. Positive real rates of interest on deposits and loans, non-preferential interest rates on central bank rediscounting, low and uniform reserve requirements, and limited targeting are the most basic goals of policy reform. The extent and timing of these reforms must reflect the initial conditions and the political and administrative constraints in each country. An efficient division of labor and increasing competition between formal and informal intermediaries and among different institutional types (public development banks, private commercial banks, credit unions) must be promoted. The ultimate goal should be to create a market in which cost-efficient linkages among different types of participants guarantee the smooth operation of the whole system. The use of urban banks as wholesalers and of rural credit unions as retailers of funds, for example, is an attractive possibility. Increased competition and stronger linkages would make it possible, in turn, to use the power of finance to assist in the integration of other markets.

Appropriate policies and regulation, however, are not a sufficient condition for financial progress. Given the magnitude and disperion of transactions costs, only lower-cost technologies for deposit and loan activities will increase the access of large segments of the population to financial services and will make the intermediaries which provide these services viable. New financial technologies are needed to take advantage of socially profitable opportunities for expanding financial markets, for reducing uncertainty, and for managing risk. Institutional and technological innovations will have to be adapted to the size of the Central American financial markets. Appropriate financial technologies are essential for the economic use of resources in the operation of financial institutions and in order to reduce transactions costs. Technologies, institution building, and policy reforms must reinforce each other. Substantial efforts will be required, however, to implement the policy reforms, create viable institutions, and accelerate cost-reducing technological progress.

Most of the programs for economic recovery in Central America have assigned no active role to the domestic financial systems. At best, financial intermediaries have been perceived as convenient conduits to channel foreign funds, most likely to target beneficiaries and in concessionary terms, in order to take advantage of the established network of branches and institutions. Domestic deposit mobilization, the other side of the intermediation process, has been completely ignored. There is not only neglect of the functions of finance, but also potential damage. Too much foreign financial assistance, disbursed through the existing financial systems, may take the incentives to mobilize domestic resources away and may make it possible to postpone overdue reforms needed for renewed growth, stability, and efficiency. Development of the domestic financial markets, on the other hand, will be a difficult exercise. Policy and procedure reforms, experiments, and learning processes are expensive. External assistance can play a useful role, not only in inducing the changes, but also in helping to finance the set up costs, including research, training, and technical assistance, and in sharing in the costs associated with changes in institutional structures and procedures. To make these efforts successful, however, a clear understanding of the nature and role of finance and of the preconditions for the efficient performance of the system is essential.

Notes

Claudio Gonzalez-Vega is Professor of Agricultural Economics and of Economics at the Ohio State University and Jeffrey Poyo is the Director of the Development Banking Program at INCAE, in San Jose. This paper was prepared for the International Commission on Central American Recovery and Development. The authors are grateful for the comments of Prof. William Asher from Duke University on an earlier version.

REFERENCES

Adams, Dale W, Claudio Gonzalez-Vega, and J. D. Von Pischke, eds. Credito Agricola y Desarrollo Rural: La Nueva Vision. San Jose: Trejos Hnos. for The Ohio State University, 1987.

Gonzalez-Vega, Claudio. "Crisis y el Sistema Bancario Costarricense." Revista de Ciencias Economicas, Vol. V, No. 1, 1985, pp. 63-74.

Gonzalez-Vega, Claudio. Mercados Financieros y Desarrollo. Santo Domingo: Centro de Estudios Monetarios y Bancarios, 1986.

Gonzalez-Vega, Claudio. "Impacto de la Crisis Economica sobre la Movilizacion de Recursos Internos en Centroamerica." Revista de la Integracion y el Desarrollo de Centroamerica, No. 39, December 1986, pp. 129-154.

McKinnon, Ronald I. Money and Capital in Economic Development. Washington, D.C.: The Brookings Institution, 1973.

Shaw, Edward S. Financial Deepening in Economic Development. New York: Oxford University Press, 1973.